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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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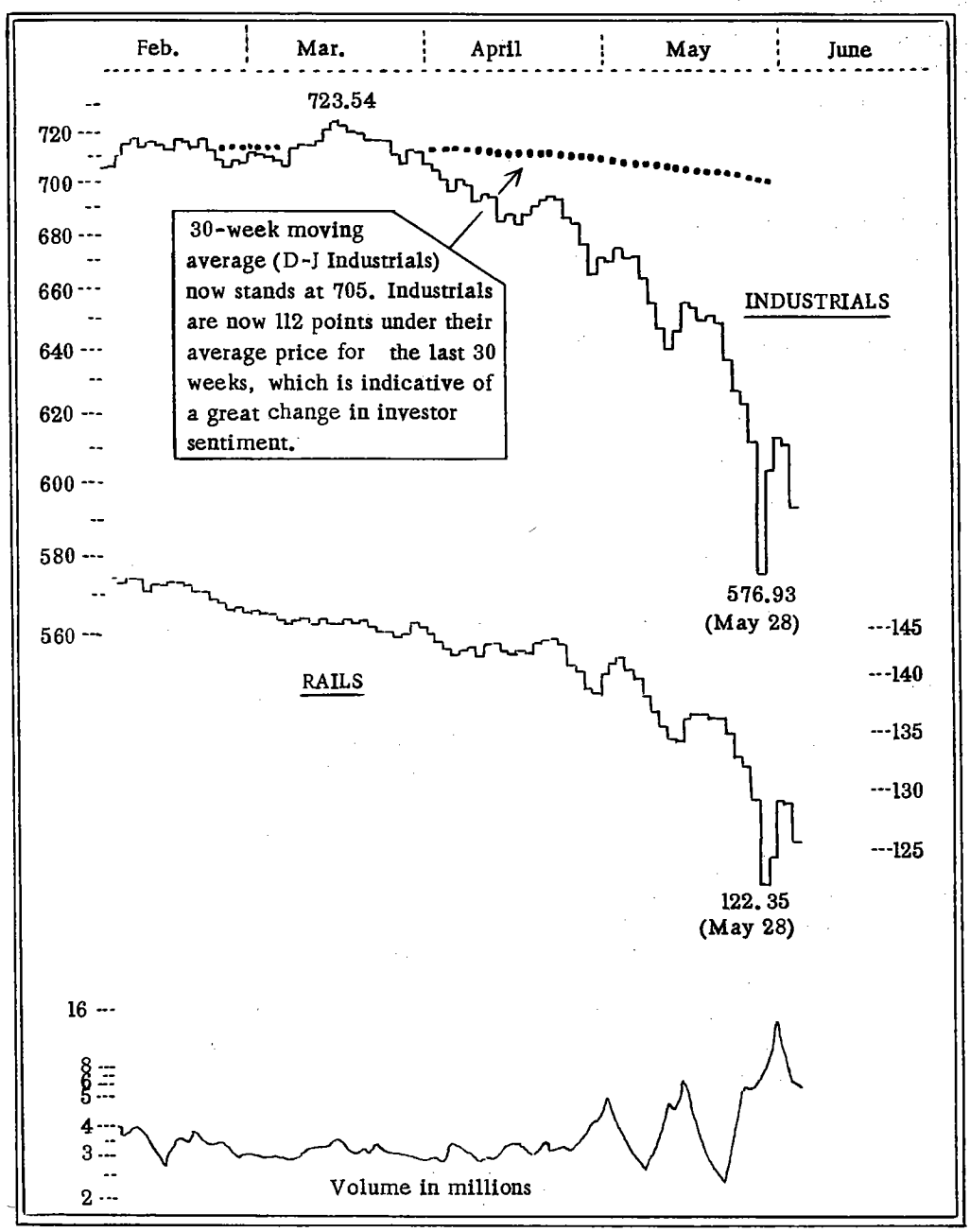
THE MARKET The second downward leg of the current bear market began for Industrials on March 15, 1962, at 723.54. The sensational action of the market through and including May 28 must be considered part or all of a panic collapse. There have only been five such collapses since the 1920's. Yet a number of things can be said about the market at this time.

(1) It is most unusual for a bear market leg to end on huge volume and a one-day reversal. May 28's volume was 9.3 million shares. May 29 saw the market drop even lower, but that day ended with the market up, on volume of 14.7 million shares (see Letter 181 for discussion of one-day reversals).

Market action during 1929 offers an interesting comparison. The second bear leg began on October 10 at 352.86. The first "crash" day came on October 24, taking Industrials to 300 on volume of 12 million shares. The second crash day came on October 29, taking Industrials to 230 on volume of 16 million shares. The actual end of the swing, however, came on November 13, and this took Industrials to a new low of 198.69 ON VOLUME OF ONLY 7.8 MILLION SHARES. Most people do not realize that the second great downward leg in 1929 did not end on huge volume. I do not know whether history will repeat, but based on crash action during 1929, 1937, and 1946, it would be unusual to see a bear leg end on great volume followed by a one-day reversal.



(2) The action following the final lows of panic declines is one of the most consistent patterns in the market. There is invariably a 40 to 60% upward correction of the entire decline (as far as the Averages are concerned). Therefore, from wherever this particular leg ends (it may have ended on May 28 at 576.93), there will be a major correction in the Averages.

Such a correction, however, does not have to be accompanied by good breadth (in other words, the action of the general market may be such that traders cannot "scalp" profits and stockholders cannot get out of most stocks advantageously).

(3) In my discussions of Dow's 50% Principle, I stated that once the halfway point of a major advance is broken, the odds favor the Industrial Average's approaching or breaking the point at which the entire move started (see Letter 182). On May 28 Industrials closed at 576.93, exactly 10.88 points above the starting point of the entire advance (566.05) in October, 1960. No one can argue that this was not a reasonable approach to the 1960 low.

(4) However, the May 28 closing of 576.93 has other and even more important implications. The halfway point of the entire advance from 1957 (419.79) to 1961 (the all-time high of 734.91) is 577.35. In order to see this, readers may refer to the chart on this page. The May 28 Industrial closing was exactly 42¢ below the halfway mark of the entire 1957-1961 rise.

Now the question is -- is 42¢ a reasonable downside penetration? Answer -- I honestly don't know. However, under the implications of Dow's 50% Principle, a decisive breaking of 577.35 will tip the market pendulum down towards the 1957 low. It is my opinion that if the Industrial Average drops decisively under 577.35, the 1957 low of 419.79 will be approached (or penetrated).

RUPTURING THE TREND The action of the Industrial Average over the past few months provides an excellent opportunity to compare the relative merits of arithmetic and ratio (or logarithmic) charting.

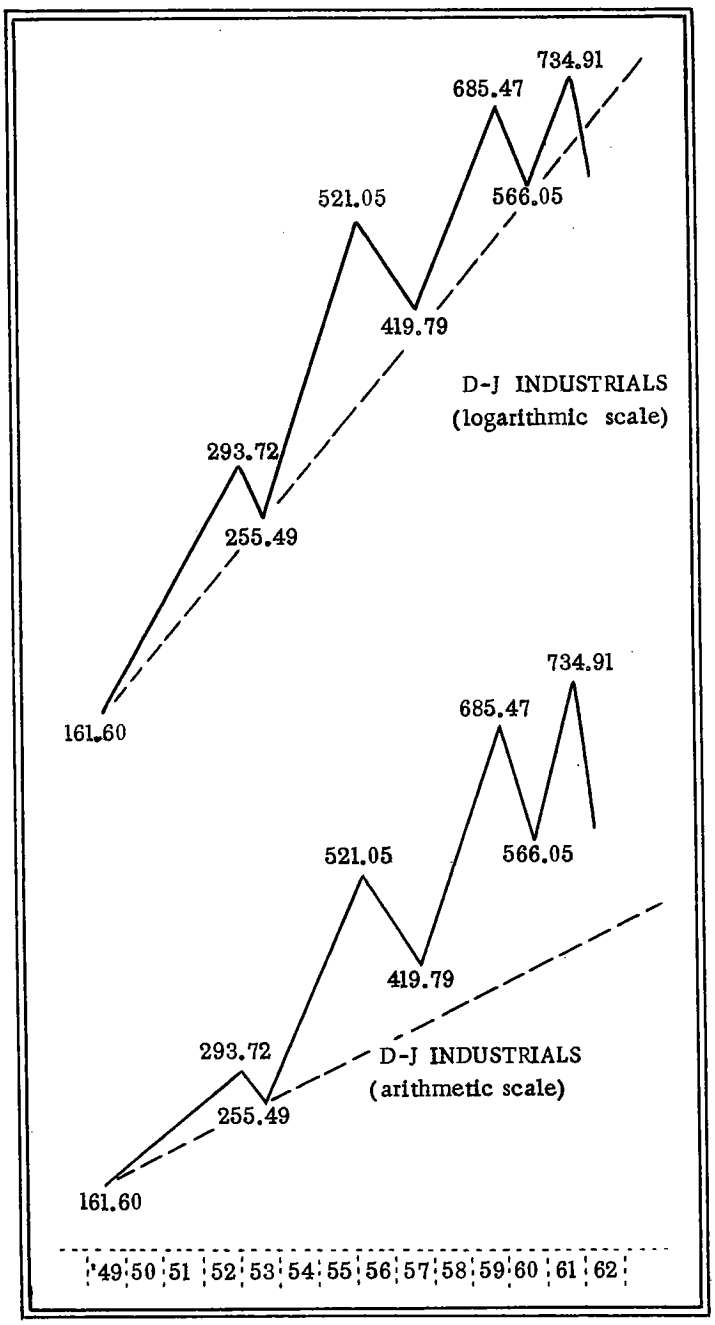
The chart at right shows the major swings of the Industrial Average from 1949 to date. The diagram at the top is scaled to logarithmic proportions; the diagram at the bottom shows the identical action scaled to simple arithmetic proportions.

Logarithmic scale is drawn so that actual percentage of movement is indicated. As the numbers increase, the scale becomes proportionally smaller. This is as it should be. Actually, a rise of 100 to 200 on the Industrial Average is equal to a 100% increase in value. But a rise from 600 to 700 (the same number of points) is equal to only a 16% rise in value. Therefore, it is deceptive to show both increases (100 to 200 and 600 to 700) as identical gains on a chart. Yet this is exactly what the lower or arithmetic diagram shows.

The Industrial rise from the 1949 low to the 1953 low established an ascending trendline. This trendline may be considered an upward "thrust", an inflation factor, or simply a specific rate of rise. On logarithmic scale, as long as this same rate or percentage of rise continued, the Industrial Average held (on all rises and declines) at or above the established trendline.

The upper diagram is significant because it shows that for thirteen years, from 1949 to 1962, the Industrial Average was able to maintain (or at times better) a certain rate of increase. Last month, for the first time since the rise began in 1949, the long-term trendline or upward momentum was shattered. This suggests that something fundamental has changed in the market. For the first time since 1949, the upward thrust has been broken -- a most significant development.

Obviously, the arithmetic chart cannot show this same picture. Since it measures only increase or decrease in pointage, the arithmetic chart in no way portrays the actual upward percentage rise or rate of increase since 1949. A break



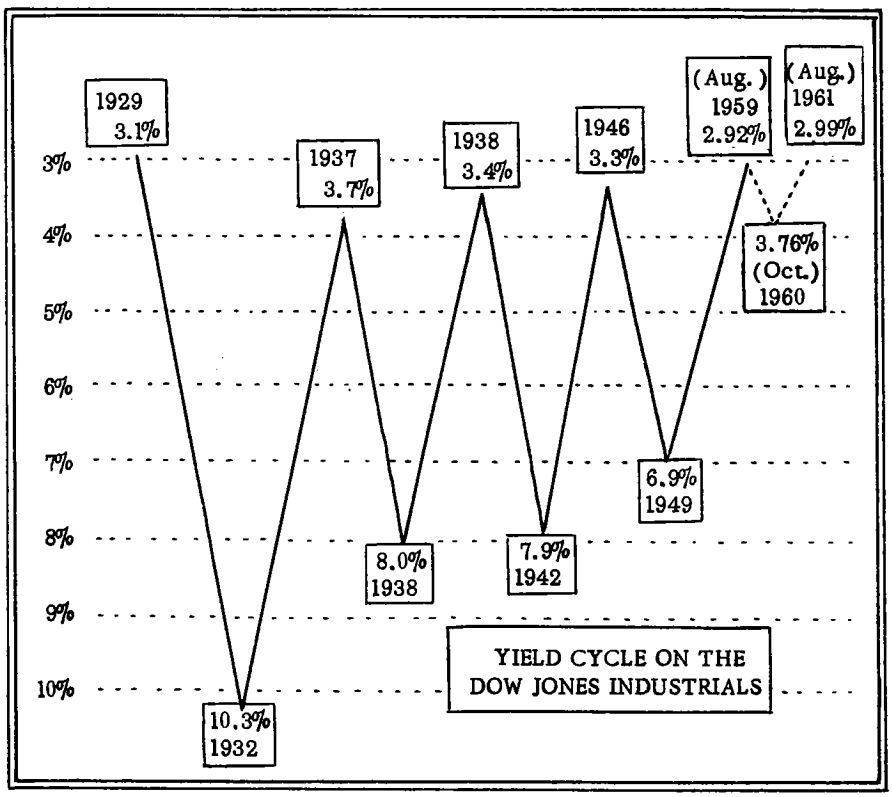
from 734 to 575 is no more meaningful on the arithmetic chart than would be a break from 300 to 40. The one thing that we are interested in is the long-term trend. This can be studied only on the logarithmic chart.

VALUES Charles H. Dow stressed the concept of values above all else. His original editorials repeatedly dealt with the necessity of buying stocks when they were "great values" and distributing stocks when they became inflated. This is a very fundamental idea, yet during a great bull market this principle is pushed further and further into the background (and the writer, also, pleads guilty to occasionally forgetting Dow's concept of values).

I have written many times since 1959 regarding the yield zones on the Industrial Average. Moreover, I have quoted Dow to the effect that "prices may fluctuate, but in the long run the trend is towards values." Dow provided us with a specific measure of values:

" Values, when applied to stocks, are determined in the end by the return to the investor, and nothing is more certain than that the investor establishes the price of stocks.

" When a stock sells at a price which returns only about 3 1/2% on the investment it is obviously dear, except there be some special reason for the established price."



The accompanying chart deals with conditions which occurred long after Dow's death. Yet the various major "tops" (see chart) suggest that Dow's concept of values was remarkably accurate. When the average yield on the D-J Industrials drops into the 3% zone, history shows that informed distribution takes place. This distribution may occur over a period of a few months or a few years. But it occurs!

The period since late 1958 represents the longest area of low yields in modern history. Perhaps coincidentally, the Industrial Average was in the 560-600 area in late 1958 when average yields first broke under the 4% level. Four years have elapsed, and measured by the Industrial Average, the market is now back in the 560-600 area. As a sheer guess, I would bet that few people can actually show profits on the majority of stocks purchased since the end of 1958. Perhaps there is a lesson to be learned in this fact alone.

Referring to the bottom part of the yield chart, it is apparent that following a period of low or unattractive yields, the Industrial Average has, in the past, swung to the other extreme. In fact, we might say that the area of 6% or above represents the general zone of attractive yields and real values.

It is somewhat dangerous to draw conclusions based on empirical evidence. "What has been" does not necessarily "have to be" again. Yet I believe every investor should make himself fully aware of the powerful long-term historical swing in yields. If this is going to be a major bear market (extending perhaps over many years), then we can expect the big picture to be a return to values.

One final point should be understood. If the Industrial Average yielded 3% at a price of 730, it does not follow that in order to go to 6% the Industrial Average must only fall to 365. During a major bear market earnings decline and dividends are reduced. Thus final average yields of 6% may ultimately take the Average below the levels which were previously considered

to be an area of great value.

Whether we will see 6% yields and true values over the next few years no one knows. But the preceding study is a basic one and should be understood by anyone who is interested in the "why's and wherefore's" of long-term stock movements.

LATE NOTE: On Monday, June 4, the market broke badly (following last week's two-day rally). As this is written (11 A.M., N.Y. time, Tuesday, June 5), the market is down again on a late tape, and more than half the gains of last week have already been erased. Odd-lotters bought heavily on the 17 point decline of June 4, a bearish omen. If both Averages break below the May 28 lows (Industrials 576.93, Rails 122.35) we can expect a further, and perhaps frightening, extension of the bear leg. A refusal of one or both Averages to break the May 28 lows will be a hopeful near-term indication.

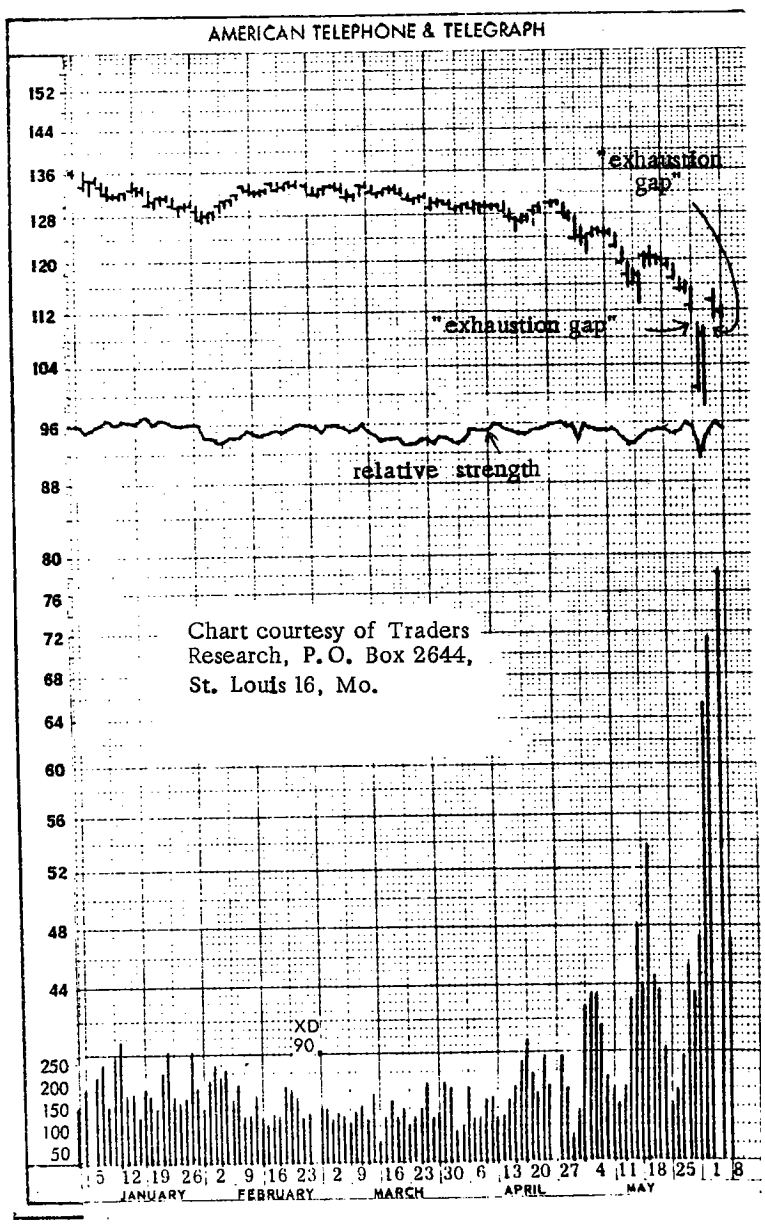
BUSINESS Barron's Business Index (heavily weighted for cyclical activity) has sustained one of its sharpest drops since 1949. The recent decline from 94.9 (January) to 82.7 (June) represents a drop of almost 13% in five months. The action of the Averages over the past few weeks suggests that a further rapid (and perhaps startlingly rapid) contraction in business may be seen over the next three to six months. Businessmen might adjust their thinking accordingly.

AN ARTICLE by the writer appears in the current (June 4) issue of Barron's. I believe the piece will interest all subscribers.

STOCKS: Of 56 stocks which are followed with particular care at this office, only two are now holding above their 10-week moving average. These two are the golds -- Campbell Red Lake and Dome Mines.

My friends at Chartcraft, Larchmont, N.Y., keep weekly trend "counts" on 500 N.Y. Stock Exchange issues. This week's tally shows that an amazing 95% of their 500 stocks are in bearish trends. Furthermore, of 76 different (Standard & Poor) industrial groups, Chartcraft now lists only 2% bullish (vs. 91% bullish at the 1961 highs). "Only golds," they comment, "are still in a strong technical position."

I have included a daily chart of the most widely distributed stock in the world, American Telephone. The chart shows a phenomenon which appeared in the majority of stocks on the panic day of May 28, 1962 -- an "exhaustion gap." Such gaps often appear following long, violent advances or declines. These gaps get their name because the immediate trend which produced them appears to have exhausted itself in one great spurt. As seen on the chart, the downside exhaustion gap in Telephone was immediately followed by a correction that was so violent that it produced what I took to be an exhaustion gap in the upward direction. Thus the rally in Telephone appeared to have terminated in a single wild day.



According to Edwards and Magee ("Technical Analysis of Stock Trends"): "An exhaustion gap, taken by itself, should not be read as a sign of a major reversal, nor even necessarily of a reversal at all. It calls 'stop', but the halt is ordinarily followed by some sort of area pattern development which may, in turn, lead either to a reversal or a continuation of the move prior to the trend. However, in practically every case, enough of a minor reaction or delay ensues from the formation of an exhaustion gap, before a new trend is established, to warrant closing out commitments at once. (One can always reenter if it subsequently appears that the previous trend is to be resumed)." In other words, when an exhaustion gap appears, close out positions and wait for the next move.